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MORE SAY ON PAY:

What Will It Mean?

BY JOHN P. HANSEN, CYNTHIA M. KRUS AND ADAM B. COHEN

Executive compensation, increased communication and transparency for shareholders are among the hot-button issues in economic reform. Momentum in the public arena, on Capitol Hill and among shareholder activists, is swinging toward allowing shareholders more access to matters of compensation. This proxy season, at least three US companies have seen a majority of their shareholders vote against their compensation plans. Further, proposals to hold such votes are receiving more support this year than in all previous years. The mainstream media has picked up on this trend as it has become evident that the landscape for Say on Pay is changing and that shareholders are looking at executive compensation with increasing scrutiny. Say on Pay is here to stay; the question now is how best to deal with this new reality. How does a company prepare for this new and uncharted environment?

Say on Pay

What is Say on Pay?

An advisory vote on executive compensation, or Say on Pay, is a non-binding proposal included in a company's proxy materials that calls for an annual shareholder advisory vote on a company's executive compensation program. Such a vote would permit a company's shareholders to give the company an annual thumbs-up or thumbs-down vote on its executive compensation program.

What is the history of Say on Pay?

The recent push to require companies to give shareholders an advisory vote on executive compensation is the result of the relative success of a similar movement in the United Kingdom, Australia, the Netherlands, Norway and Sweden. The advisory vote initiative originated in the United Kingdom and became a required corporate governance practice for all companies listed on the London Stock Exchange, beginning in 2003.

A concerted effort by activist shareholders and certain large institutional investors brought the issue to the forefront in the United States. In 2006, several activist shareholders and institutional investors began to pressure certain public companies to include a Say on Pay proposal in their respective proxy statements. Proposals to require an annual Say on Pay vote were adopted by shareholders at five publicly traded companies that year, expanding to more than 50 in 2007, more than 80 in 2008, and exceeding 100 in 2009. In January 2009, the American Federation of State, County and Municipal Employees (AFSCME) and Walden Asset Management (Walden) announced that they were leading a coalition of more than 70 institutional and individual investors in an effort to file Say on Pay proposals with more than 100 companies.

With respect to the 2010 proxy season, ISS Voting Analytics reports that, as of June 30, 2010, 140 Say on Pay proposals have been put forward, and more than 120 companies have voluntarily adopted advisory votes on compensation. Overall, RiskMetrics expects approximately 300 Say on Pay proposals this proxy season.[1]

Say on Pay actions to date

Although legislative proposals broadly requiring Say on Pay at all public companies have not been implemented, investors have sought Say on Pay votes through shareholder proposals at many companies in 2010. This proxy season, proposals to put Say on Pay on the ballot received 51 percent of the vote at EMC, 47.9 percent of the vote at Johnson & Johnson and 45.3 percent of the vote at IBM. The number of votes exceeded support for the same resolutions at the three companies last year. In response, many companies have voluntarily adopted Say on Pay policies. For example, Aflac, Alaska Air, Apple, Intel and Verizon Communications all had voluntary advisory votes on executive compensation in 2009.

Until recently, it seemed as though the movement toward requiring Say on Pay votes did not necessarily translate into votes against management compensation policies. Some questioned if Say on Pay measures "lacked teeth," or if ordinary investors just did not consider pay to be an issue. However, on May 5, 2010, only 46 percent of Motorola shareholders voted in support of the company's compensation plan, marking the first time that a US company failed to earn majority support from shareholders on compensation. Motorola gave its shareholders a Say on Pay vote in 2009 and their compensation plan received the support of 64 percent of shareholders, one of only four companies to receive less than 65 percent approval that year.

The same week, on May 8, the shareholders of Occidental Petroleum Corp. (Occidental) also voted against the company's compensation practices. Occidental voluntarily began offering shareholders a non-binding vote on compensation in 2009. After the May 8 shareholder meeting, Occidental's spokesman was quoted in *The Wall Street Journal,* stating that the "compensation committee will continue to expand its dialogue with institutional investors to assess the views and will use that input to re-evaluate the company's compensation philosophy, objectives and policies."

On May 21, KeyCorp, an Ohio-based banking firm, became the first Troubled Asset Relief Program (TARP) participant to get majority dissent over its pay practices.

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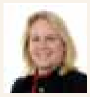

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KeyCorp received only 45 percent support during its Say on Pay vote, in stark contrast to the 87.2 percent approval it received during its 2009 advisory vote. As was the case with the Occidental and Motorola votes, there were no organized campaigns against the pay package at KeyCorp. At all three companies, the outcome of the Say on Pay votes were a result of a purely grassroots movement.[2]

Although it is premature to call it a trend, the expressions of discontent among the shareholders at KeyCorp, Occidental and Motorola do signal that the financial crisis has ignited increased shareholder awareness with respect to corporate governance. Some companies have reduced CEO pay, partly as a result of the recession, government intervention as a result of bailouts,[3] and because of increasing shareholder activism. Some shareholders voting against compensation plans cite the latest market downturn and perceived excesses in corporate America as the reasons behind their votes. However, note that none of the three companies that failed to obtain majority support for their respective executive pay packages were Wall Street banks.

Since the votes are non-binding, the May votes at KeyCorp, Occidental and Motorola do not have any immediate impact on their respective compensation programs or pay decisions. How the companies move forward in their individual dealings with major shareholders on executive compensation practices will set the stage for future engagement on the topic of compensation.

What benefits are associated with Say on Pay?

Proponents of Say on Pay claim that implementing an advisory vote on executive compensation will incentivize public companies to think about *how* and *why* they arrived at specific executive compensation decisions and, in turn, will create better disclosure. In particular, some proponents argue that the potential for public censure regarding excessive executive compensation packages will lead directors to restrain excessive executive compensation in response to shareholder sentiment and more directly link pay with performance. Other proponents claim that Say on Pay will affect executive compensation levels in more indirect ways. For instance, Say on Pay would promote dialogue with, and feedback from, shareholders. Also, Say on Pay would give shareholders a sense of empowerment without binding the company to anything. Furthermore, compensation committees might be able to use advisory votes to their advantage, as a way to provide cover for the committee and the board as a whole, when negotiating compensation with managers.

What costs are associated with Say on Pay?

Opponents of Say on Pay claim that an advisory vote on executive compensation will be ineffective, costly and confusing. They believe that Say on Pay is ineffective because a simple thumbs-up or thumbs-down vote on executive compensation gives management little information about the specific components of executive compensation to which shareholders object. Opponents argue that such an advisory vote is unnecessary and confusing because shareholders are already receiving detailed information on executive compensation as a result of the Securities and Exchange Commission's (SEC's) executive compensation disclosure rules. Opponents also claim that an advisory vote will be costly because it will require companies to spend a significant amount of time engaged with various corporate governance activists and proxy advisory firms each year, explaining their executive compensation practices and determinations to ensure that the advisory vote is in their favor. Finally, opponents fear that activist groups that support Say on Pay might use advisory votes as an inroad to promote their own social or political agendas that are not related to the company's economic growth.

Say on Pay for TARP recipients

Congress passed the American Recovery and Reinvestment Act of 2009 (the 2009 Recovery Act) on Feb. 13, 2009, and President Obama signed it into law on Feb. 17, 2009. In addition to providing federal investment in energy, transportation and infrastructure, and education and health care projects, the 2009 Recovery Act expanded the executive compensation restrictions set forth under the Emergency Economic Stabilization Act of 2008 (the EESA) for entities participating in TARP. Notably, § 7001 of the 2009 Recovery Act requires each TARP recipient to provide its shareholders with an advisory, non-binding vote on executive compensation at its annual meeting of shareholders. On June 15, 2009, the US Department of the Treasury (Treasury) released an Interim Final Rule implementing the executive compensation and corporate governance standards under the 2009 Recovery Act. These standards generally apply to all recipients of funds under TARP, except for TARP recipients not holding outstanding obligations.

The Interim Final Rule consolidates and supersedes all prior guidance issued by the Treasury on this topic, including the initial executive compensation rules issued under the EESA in October 2008, and the executive compensation guidelines announced by Treasury in February 2009. As set forth in the Interim Final Rule, shareholders of any institution that has received or will receive financial assistance under TARP are provided with an annual non-binding Say on Pay vote to approve the compensation of the institution's executives. Treasury Secretary Timothy Geithner outlined best practices for a compensation program in the context of Say on Pay for TARP recipients.

The practices include:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risk;
- Compensation practices should be aligned with sound risk management;
- Golden parachutes and supplemental retirement packages should be re-evaluated; and
- Compensation programs should promote transparency and accountability in the compensation-setting process.

Say on Pay for all

The Wall Street Reform and Consumer Protection Act (the Dodd Frank Act), containing specific Say on Pay requirements, passed the Senate on July 15, and was signed into law by President Obama on July 21, 2010. The Dodd Frank Act, while primarily focused on financial regulations, also includes numerous measures affecting corporate governance and Say on Pay, specifically. These are measures that, according to President Obama, will allow shareholders "greater say on CEO pay so they can reward success instead of failure."

The events leading up to the passage of the Dodd Frank Act are informative in understanding its final form. In an effort to address the public outcry over executive compensation, and consistent with the financial regulatory reform initiatives announced by the Obama administration, the Treasury submitted draft legislation to Congress in July 2009, entitled the Investor Protection Act of 2009 (the Treasury Legislation). Similar to the Dodd Frank Act, the Treasury Legislation would have required all public companies to put their executive compensation to a non-binding, advisory vote by such company's shareholders at any annual meeting held after Dec.15, 2009.

The Treasury Legislation also included a similar provision requiring a non-binding, advisory shareholder vote on any "golden parachutes" to be awarded to a company's executive officers in connection with a business combination transaction. Finally, similar to the Dodd Frank Act, the Treasury Legislation would have amended the Securities Exchange Act of 1934 (the Exchange Act) to establish independence standards for board of directors' compensation committees of public companies.[4] This new section would provide compensation committees with the authority to hire independent compensation consultants, legal counsel and other advisers, and address the independence standards for these hired people.

The House of Representatives (the House) passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (the 2009 Legislation) on July 31, 2009, by a vote of 237-185. The 2009 Legislation generally follows the contours of the Treasury Legislation and includes Say on Pay for all public companies; an independent compensation committee requirement and incentive-based compensation for public companies; and disclosure requirements applicable to financial institutions with $1 billion or more in assets. In a party-line vote, Congress rejected an amendment that would have required an advisory vote only once every three years, and would have allowed companies to opt out of advisory votes for five years with the approval of a two-thirds investor vote. The 2009 Legislation was subsequently incorporated into the Wall Street Reform and Consumer Protection Act of 2009 (the House bill), which passed the House by a vote of 223-202 on Dec. 11, 2009.

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On May 21, 2010, the Senate passed the Restoring American Financial Stability Act of 2010 (the Senate bill), which would reform the regulation of financial products and services in response to the recent economic crisis. The Senate bill generally expanded on the corporate governance provisions contained within the House bill. For example, the Senate bill provided for annual disclosure in a company's proxy statement of the ratio between the total annual compensation of all employees (other than the CEO) and the annual total compensation of the CEO, as well as majority voting standards for directors in uncontested elections. Notably, the Senate bill also would have added to the Exchange Act a rule requiring advisory votes on compensation at annual meetings; unlike prior iterations of financial regulatory reform legislation, the Senate bill did not contain a provision requiring a non-binding shareholder vote on "golden parachute" payments made to executives upon change of control. The Senate bill made clear that the vote was to be non-binding and would not impose any additional fiduciary duties on the issuer company or its board of directors. Unlike the House bill, the Senate bill does not specifically direct the SEC to issue rules on Say on Pay voting, nor does it exempt smaller issuers.

The Wall Street Reform and Consumer Protection Act (the Dodd Frank Act), the result of the reconciliation of the House bill and Senate bill, was released on June 28, 2010, and was passed by the House on June 30, 2010, by a vote of 237 to 192. The Senate voted 60 to 38 on July 15 to limit debate on the Dodd Frank Act, allowing the Dodd Frank Act to be passed by a vote of 60 to 39 in the Senate. With the Senate's approval, the Dodd Frank Act was sent to President Obama and signed into law on July 21, 2009.

The Dodd Frank Act generally takes the approach to Say on Pay contained in the Senate bill. Most importantly, the Dodd Frank Act includes a requirement for a Say on Pay vote. Notably, while the Senate bill contemplated annual Say on Pay votes, the Dodd Frank Act requires public companies to provide in their proxy statements a separate resolution to determine the frequency of Say on Pay votes. At the first annual or other shareholder meeting occurring six months after the enactment of the Dodd Frank Act, issuers are required to put to a shareholder vote whether to hold Say on Pay votes annually, biennially or triennially. Thereafter, shareholders must again be provided the opportunity to vote on the frequency of Say on Pay votes at least once every six years. This provision has raised several interpretive questions, including whether this frequency vote will be binding upon issuers.

The Dodd Frank Act further specifies that the Say on Pay vote would not be binding on the company's board of directors and could not be construed as overruling any company or board decision, changing or creating any additional fiduciary duties for the company or board, or limiting the ability of shareholders to submit executive compensation proposals for inclusion in the company's proxy materials. During the conference process, a further provision was added to allow the SEC the authority to exempt companies from the Say on Pay requirements after taking into account, among other considerations, whether they would disproportionately burden smaller companies.

Like the House bill, the Dodd Frank Act provides for a non-binding shareholder vote on "golden parachute" payments if shareholders are otherwise being asked to vote on a corporate transaction. The Dodd Frank Act also would require listed companies to develop and implement policies providing for:

(1) disclosure of the company's policies on incentive-based compensation based on reported financial information; and

(2) recovery ("clawback") of "erroneously awarded" incentive compensation paid to current or former executive officers, following an accounting restatement because of material non-compliance with financial reporting requirements under securities laws.[5] For the purposes of a clawback, erroneous compensation would consist of the excess incentive compensation paid during the three years preceding the restatement.

The Dodd Frank Act also includes requirements for expanded disclosure regarding the relationship between executive pay and company performance, and the ratio of CEO compensation to the compensation of the rest of the employees of the company.

What to do next

A Say on Pay vote against a compensation plan has no legal ramifications and is merely advisory. It is possible that the compensation committees at Occidental and Motorola will restructure their executive compensation plans wholesale, adjust CEO take-home pay or pursue other approaches to respond to the shareholder votes against their compensation program. While the bottom-line reaction to the shareholder votes is unclear, it is clear that the shareholder vote will be heard.

Importance of shareholder communication

For companies that find themselves in the position of Motorola and Occidental, the first step is to determine the root cause of the 'no' vote, thereby reducing guesswork going forward. This can be done through steps such as consulting analytical reports prepared before the meeting by proxy advisory and governance research firms, arranging meetings with key investment and trade organizations, soliciting meetings with representatives of major fund owners, and reviewing both media reporting about the company's compensation policies and correspondence sent to the company by dissenting shareholders.[6]

It bears mention that the first British company to have its executive compensation scheme rejected by shareholders, GlaxoSmithKline in 2003 (the first year of Say on Pay in the United Kingdom), has made a concerted effort in the years since to build outreach to shareholders into routine preparations for annual votes. GlaxoSmithKline now arranges an annual consultation process on remuneration and governance. The chair of the compensation committee conducts at least two roundtables with investor representatives in two cities within the United Kingdom, as well as in the United States. While overall executive compensation across the United Kingdom has grown since 2003, it has done so at a slower pace and with more linkage of variable pay to performance targets. However, the result of the British Say on Pay movement is most clearly seen in the increase in shareholder communication by public companies.[7]

> Investors likely **will not consider compensation committees** to be sufficiently independent unless all members are completely **independent from management** (including **"soft" relationships,** such as pre-existing friendships and **interlocks on charitable foundation boards).**

Consultation regarding compensation plans should aim to build constructive relationships between investors and directors and could involve the following steps:

- Companies should identify key shareholders, trade associations, proxy agents and potentially media outlets that have the capacity to influence investor and public opinion on compensation matters;
- Prepare an outreach plan well before the annual meeting;
- Consult with institutional shareholders before the compensation plan is finalized so the board can receive early notice of potential dissent, and consider revisions or strategies to defend decisions;
- Offer meetings with the chair of the compensation committee and/or other board members with key market players and compensation consultants; and
- Pay close attention to the disclosure provided in the Compensation Discussion and Analysis (the CD&A) of the annual proxy statement as a persuasive device that requires adequate scrutiny by the company and its board prior to being released publicly.

To the extent a company's compensation philosophy and pay practices differ greatly from those of other peer compa-

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- *The New Deferred Compensation Rules: An Issue-Spotter's Guide to Tax Code Section 409A (July 2008*). In 2007, the IRS issued the final regulatory guidance on Section 409A. The 397-page document, however, brought up more questions than it answered. This article explains tax code Section 409A and highlights the deferred compensation rules for in-house counsel. *www.acc.com/docket/taxcode409a_jul08*
- *The Ten Elements of a Proxy Contest Settlement (April 2008).* Hopefully your company will never have to defend itself against a proxy contest brought on by a major activist shareholder. However, if you do find yourself settling a proxy contest and drafting a settlement agreement, refer to this article — which lists 10 elements that the agreement should contain. *www.acc.com/docket/10proxysettle_apr08*

Quick References

- *Top Ten Lessons Learned by CLOs About Executive Compensation from the Stock Options Crises (Jan. 2007).* A variety of ideas to improve in-house counsel's ability to navigate compensation concerns in light of the ongoing backdating scandals are included here. *www.acc.com/quickref/10CLOexecomp_jan07*
- *Corporate Governance Principles (Jan. 2003).* Read this guide to the composition of a company's corporate governance structure. It includes role and composition of the board of directors, the functioning of committees and periodic review. *www.acc.com/quickref/corpgovpr_jan03*
- *Board of Directors Compensation and Leadership Development Committee Questionnaire (Nov. 2003).* View this board of directors questionnaire regarding compensation and leadership performance. It includes questions on structure and effectiveness, membership and more. *www.acc.com/bod-comp&ldquest_nov03*

Articles

- *Do Not Find Yourself in an Executive Compensation Dilemma (Oct. 2009).* This article explores governance issues, executive compensation plan designs, non-qualified deferred compensation plans under Section 409A of the Internal Revenue Code, severance plans, special distribution rules applicable to key employees and more. *www.acc.com/execomp_oct09*
- *The Case for Subsidiary Corporate Governance (Oct. 2009).* This article discusses the importance of using subsidiaries or special purpose entities as a means to conduct business and related corporate governance best practices. *www.acc.com/subsidcorpgov_oct09*
- *Executive Pay: Conflicts of Interest Among Compensation Consultants (Dec. 2007).* This report examines whether the compensation consultants hired by large publicly traded companies meet the standard of independence required. It includes extent and disclosure of compensation consultant conflict of interests, and more. *www.acc.com/compensation-conslts_dec07*

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nies, a company should be able to clearly define the reasons for such discrepancies and pay practices. In so doing, however, companies should be sensitive to not run afoul of the SEC's Fair Disclosure Regulation (Reg FD), and should provide participating directors training on Reg FD.[8]

What actions companies are taking today

There are several steps that companies have begun to take to prepare for the eventuality of Say on Pay, hoping to minimize the possibility that their compensation plan may fail to receive majority support. These actions address the changing regulatory landscape with respect to executive compensation, as well as areas that typically draw increased shareholder attention.

Compensation committees

As compensation committees and their independence have been addressed repeatedly in both legislative and regulatory arenas, shareholders will undoubtedly look to this topic in assessing a company's compensation plan. Compensation committees are of particular importance to shareholders given that the committee is an effective way to provide independent oversight of executive compensation. In December 2009, the SEC issued new proxy disclosure rules that, among other changes to a company's annual proxy statement, expanded the disclosure required when compensation consultants play a role in the determination of the amount or form of executive or director compensation. Further, the Dodd Frank Act contains new requirements for compensation committee independence, compensation consultant independence, and a compensation committee's use of compensation consultants, legal counsel and other advisers.

Although contemplated by the Dodd Frank Act, securities law as it exists today does not require listed companies to have wholly independent compensation committees (although it is considered to be a best practice). Investors likely will not consider compensation committees to be sufficiently independent unless all members are completely independent from management (including "soft" relationships, such as pre-existing friendships and interlocks on charitable foundation boards). As such, public companies are revising their committee charters to provide for total independence of compensation committee members. Further, in response to the pressure provided by the new proxy disclosure requirements and pending legislative proposals, companies are similarly revising committee charters to allow the compensation committee to engage independent compensation consultants, legal counsel and other advisers.

Golden parachutes

Payments to executives on or following a change in control, often referred to as "golden parachutes," have long been subject to scrutiny. Companies generally believe that these programs are important in minimizing the employment-related distractions that executives might otherwise have in the event of a corporate transaction. Shareholder groups have argued that golden parachutes are unnecessary and provide executives with an inappropriate windfall. In 1984, Congress attempted to address this concern through the Internal Revenue Code (the Code) by disallowing the tax deduction and imposing a 20 percent excise tax on golden parachute payments above a certain threshold. However, golden parachutes have continued as a feature of executive compensation programs.

Golden parachutes have been singled out in legislation dating back to 2007, and are subjected to additional disclosure and shareholder votes. They also are watched carefully by proxy advisory firms and individual shareholders. As a consequence, some companies have begun modifying or revising agreements to address shareholder concerns regarding golden parachutes. With the new requirement of a non-binding shareholder vote on golden parachutes contained in the Dodd Frank Act, companies will likely increase their focus on these types of arrangements.

One of the most significant changes in recent years has been the transition from "single trigger" equity vesting to “double trigger” equity vesting. Single trigger vesting entitles executives to benefits in the event of a change in control, regardless of its impact on their job. In response to shareholder pressure with respect to change-in-control agreements, some companies have instead put in place “double trigger” plans that require the company to have a change in control, and for the executive’s position to be eliminated or the acquiring company to not assume or replace the executive’s equity awards. Some companies have gone even further and chosen to eliminate change-in-control provisions completely from their compensation plans. Similarly, many companies have severance arrangements that offer the executive an opportunity to voluntarily terminate employment and receive severance payments for any reason following a change in control.. Some companies are modifying these arrangements to provide severance following a change in control only if the executive is involuntarily terminated or if the executive voluntarily terminates employment for certain “good reason” events.

With the **new requirement** of a **non-binding shareholder vote** on golden parachutes contained in the **Dodd Frank Act**, companies will **likely increase their focus** on these types of arrangements.

Tax gross-ups

As noted above, the Internal Revenue Code imposes adverse tax consequences on “parachute payments,” including a 20 percent excise tax on amounts in excess of a safe harbor amount. In response to the Code provisions, companies have paid an individual’s excise and related income taxes in an effort to offset the excise tax and keep the individual whole. In 2009, RiskMetrics added “providing an excise tax gross-up or modified gross-up” to its list of “poor pay practices” for new or materially amended agreements.[9] As a result, some companies that previously provided for such gross-up arrangements have modified or eliminated the excise tax gross-up altogether. In some cases, the companies have replaced the excise tax gross-up with a “best payment” provision that pays the executive either the full parachute payment or a reduced amount, whichever will leave the executive in the best after-tax position, taking into the account the excise tax.

Other types of income tax gross-ups — for example, a gross-up for the imputed income tax imposed on the executive’s personal use of corporate aircraft — are also viewed unfavorably by shareholder groups. Many companies have eliminated such provisions, in some cases replacing them with a fixed cash allowance intended to provide the executive with funds that they can choose to use to pay the taxes or for other purposes.

Clawbacks

Clawback provisions, which require bonuses and long-term incentive compensation to be repaid to the company in the event of a financial restatement or other circumstances, have become significantly more common in recent years.[10] Although § 304 of the Sarbanes-Oxley Act provides for a clawback of certain compensation paid to a company’s CEO or CFO, institutional investors and shareholder groups have indicated their desire for more expansive clawback provisions, including provisions that apply to executives beyond the CEO and CFO, to a wider range of misconduct, and for a longer period of time following the misconduct. The Dodd Frank Act would provide for mandatory clawback policies for any issuer required to prepare an accounting restatement based on material noncompliance with federal securities financial reporting requirements.

Clawback provisions can take a variety of forms. Some clawbacks require amounts to be repaid only if the executive engaged in improper activity that resulted in a financial restatement, affecting the amount of the bonus or other compensation. Other clawbacks are broader, requiring repayment if there was any misconduct affecting the amount of compensation, regardless of whether the executive was involved or whether it resulted in a restatement. Under some clawback policies, amounts must be repaid even if the executive’s misconduct was detrimental to the company in other ways, without affecting the amount of the compensation. The time period for enforcing a clawback also varies. Although a 12-month period is most common, some clawbacks continue to potentially be applicable for three years or more following payment of the compensation. Finally, some companies have expanded clawback policies beyond annual bonuses to include gains on stock options and amounts received pursuant to restricted stock or stock units. Policies implicating equity compensation raise questions regarding whether repayment should be based on the stock value at the time of exercise or vesting, or the stock value at the time of repayment, among other issues.

Although clawback provisions have proliferated in recent years, the enforceability of clawback provisions remains relatively untested. For example, in some states, “wage payment” laws prohibiting unauthorized deductions from wages could be relevant, depending on the extent to which the relevant compensation is considered “wages,” and whether the executive explicitly agreed to the clawback policy. Clawbacks that are triggered by violations of restrictive covenants, such as a noncompete or confidentiality provision, could be held to be against public policy in certain states and then disallowed on that basis. However, it has become more common to include clawback provisions in employment agreements.

Performance-based equity compensation

Shareholder groups and other critics of executive compensation practices frequently focus on the extent to which compensation is tied to company performance. As a result, many companies have replaced traditional restricted stock or restricted stock units, which vest solely on the basis of continued service, with performance-vesting stock or stock units. These arrangements typically still require a period of service for vesting, such as three years, but also require that the company satisfy certain target performance measures by the end of that service period (or during some portion of the service period) in order to vest. Common performance measures include share price, earnings per share and total shareholder return.

Another aspect of equity-based compensation that has received shareholder scrutiny is the treatment of dividends on restricted stock, and dividend equivalents on restricted stock units. Under many such arrangements, the dividends and dividend equivalents are paid out as earned, even though the underlying restricted stock or stock units are not yet vested. Although this comports with the treatment of actual shareholders, it arguably provides an element of compensation that has not been earned by satisfying service-based or performance-based vesting requirements. Accordingly, some companies are instead utilizing a design in which dividends and dividend equivalents are accumulated and paid out, if and when the underlying equity award becomes vested.

Understanding shareholder triggers

One of the easiest steps to take with respect to a vote against a compensation plan is to avoid the negative vote in the first place. Several shareholder groups, including the Council of Institutional Investors, have publicly released lists of “red flags” that shareholders should look for when voting on compensation plans. Understanding what shareholders may deem “problematic” can help companies

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avoid the possibility of dealing with majority dissent during a Say on Pay advisory vote. Among the triggers given to shareholders as cause for voting down a compensation proposal are:

- a CEO base salary of more than $1 million;
- the award of a bonus to the CEO in addition to non-equity incentive compensation;
- a lack of correlation between company performance and annual cash incentives awarded to the CEO;
- a pay differential between the CEO and other named executive officers (NEOs) of more than three to five times the average of other NEOs;
- a change in pension value and non-qualified deferred compensation earnings that is larger than other elements of pay;
- an "all other compensation" column that is disproportionately large and contains excessive perks;
- profits made on the exercise of stock options and value realized on the vesting of equity awards that does not match long-term performance;
- annual performance and long-term incentive bonuses that are based on the same, single performance metric;
- payment of incentives for below-median performance; and
- any perception of conflict of interest in change of control payments.[11]

What the CLO needs to know

Because Say on Pay will be in place by the 2011 proxy season, companies and investors should take the time now to prepare for mandatory Say on Pay votes in the future. It is also advisable that public companies evaluate the professional advisors their compensation committees engage, and the actual composition of their compensation committees so as to ensure they meet the applicable independence standards.

Public companies and their compensation committees should evaluate their responses to the following questions in preparing for the implementation of Say on Pay proposals, and should consider taking the opportunity to increase communications with shareholders in the process of responding:

- *Oversight.* Is the company able to show that its board is overseeing executive compensation effectively? Does disclosure appear suggestive that unmet performance goals may still be compensated?
- *Comparisons to peer companies.* Is the process used by the company reasonable in relation to other companies of the same size or in the same industry? Are the lists of pay peers provided in the CD&A described sufficiently and are they the actual comparative companies the company uses?
- *Compensation metrics.* What metrics are used to evaluate performance? How are those metrics related to business strategy? Is there a clear link between compensation and performance?
- *Compensation committees.* Is the company using a compensation consultant? If so, is the consultant independent? Is the compensation committee adequately composed of independent directors?
- *Proxy statement disclosure.* Is CD&A disclosure helpful in understanding the company's compensation structure? Does the narrative disclosure provided explain how the overall pay program ties compensation to strategic goals, and the creation of long-term shareholder value?
- *Shareholder value.* Are there techniques employed to align pay and shareholder value? Is the company responsive to shareholder input?
- *Average pay ratio.* How will this new disclosure requirement be calculated and determined? How does a company with extensive operations calculate this range, particularly one with international operations?

A confluence of economic, political and business conditions has produced a tipping point for Say on Pay. At a minimum, it appears that shareholders will have more opportunity to express their views on compensation. Boards and their legal advisers need to be prepared for this exchange. More time spent preparing for such input will help companies navigate this new corporate governance environment.

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Notes

1 Last year, there were 140 Say on Pay proposals included in proxy materials among the Russell 3,000; supporters constituted an average of 85.4 percent of votes cast. See also *www.riskmetrics.com/knowledge/proxy_season_watchlist_2010* (last visited July 22, 2010).

2 Broc Romanek, "Say-On-Pay So Far: Wow! A Third Company Fails to Gain Majority Support," *thecorporatecounsel.net, www.thecorporatecounsel.net/blog/2010/05/say-on-pay-so-far-wow-a-third-company-fails-to-gain-majority-support.html.*

3 "Pay czar" Kenneth Feinberg on March 24, 2010, announced further pay cuts for top executives at five firms receiving TARP assistance, reducing cash payments to the top 25 executives at each of the companies by 33 percent, on average, compared with 2009 levels.

4 Note that the ability to retain and hire consultants, legal counsel and advisers at the company's expense is already a best practice for the vast majority of compensation committees of public companies and is commonly evidenced in their compensation committee charter.

5 This would expand the clawback provision contained in the Sarbanes-Oxley Act of 2002, which applies only to compensation received by the CEO and CFO and then only during the 12-month period following the first issuance of the restatement and only if the restatement resulted from misconduct.

6 Stephen Davis, "Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable," Millstein Center for Corporate Governance and Performance, Yale School of Management, available at *http://millstein.som.yale.edu/policy%20briefing%20no%201%20'say%20on%20pay'.pdf.*

7 The Association of British Insurers estimates that since 2003, contacts initiated by British companies before compensation plans are finalized have tripled. These consultations varied from phone calls to multiple high level meetings.

8 For example, one of the best ways to avoid running afoul of Reg FD is to focus on governance matters under the board's purview.

9 See, 2009 Compensation FAQs: Section 1: Poor Pay Practices, RiskMetrics Group, *www.riskmetrics.com/policy/2009_compensation_FAQ.*

10 An Equilar study of clawback provisions showed an increase in Fortune 100 companies with clawbacks from 17.6 percent in 2006 to 72.9 percent in 2009. See *www.equilar.com/press_20091118.php.*

11 Paul Hodgson, "A 10-Point Test: When We Have Say on Pay, How Will I Decide Whether to Vote Yes or No?" The Corporate Library, available at *http://info.thecorporatelibrary.com/say-on-pay-how-to-vote-yes-or-no/default.aspx?rewritestatus=3&utm_campaign=say-on-pay&utm_source=tcl-homepa.*